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Date:
December 20, 2011

Legend

Taxpayer: =

Annuity Contract: =
Rider: =

Dear :

This is in response to your request for a ruling that a rider to be offered with certain annuity contracts constitutes an “insurance contract” for purposes of § 7702B(b)(1) of the Internal Revenue Code.

## FACTS

Taxpayer represents as follows:

Taxpayer is a stock life insurance company taxable under § 801 and is the issuer of Annuity Contract, which is a single premium deferred annuity contract with purchase payment requirements. Annuity Contract is available as an individual or group annuity contract. An individual contract is issued to Owner; a certificate under a group contract is issued to Participant; for purposes here Owner and Participant are synonymous. Annuity Contract is not a variable contract within the meaning of § 817(d).

Taxpayer proposes to offer a noncancellable rider option (Rider) for Annuity Contract which will provide certain long-term care benefits (LTC Benefits) during the time the person covered (Specified Person) by the Rider is a chronically ill individual with the meaning of § 7702B(c)(2)[1] and receiving qualified long-term care services within the meaning of § 7702B(c)(1) through the agency or facility identified in the plan of care. Taxpayer intends that, except as discussed in this letter ruling, the Rider otherwise satisfies the requirements for a qualified long-term care insurance contract of § 7702B.

Subject to elimination and waiting period requirements, the Rider provides monthly LTC Benefits that reimburse expenses for certain long-term care services during the periods when the Specified Person is a chronically ill individual; that is, if the Specified Person recovers from the chronic illness, LTC Benefits cease. The expenses for long-term care services reimbursable under the Rider are typical of those reimbursable under stand-alone qualified long-term care insurance contracts.

The LTC Benefits are payable to the Owner.

Prior to annuitization LTC Benefits are payable during two consecutive phases, Phase I and Phase II. At issuance, the Owner can choose among alternative groupings of lengths, in terms of months, for each Phase, and the lengths will be specified in the Rider. Once the Rider is issued, the length of each Phase cannot be changed.

During both Phases, the maximum LTC Benefit payable in a given month is the lesser of the Monthly Benefit Cap prorated based on the number of days during the month which the Specified Person received qualifying services and the amount of qualifying expenses actually incurred. The Owner can elect to receive an amount less than the Monthly Benefit Cap.

The amount of LTC Benefits payable is determined by reference to the Annuity Contract's Contract Value, which is the sum of the premiums paid, plus credited interest, less withdrawals and applicable charges. The Monthly Benefit Cap is the Contract Value at the time of a claim for LTC Benefits divided by the length of scheduled length of Phase I. Once determined, the Monthly Benefit Cap does not change unless there is a withdrawal from the Annuity Contract, in which case the Monthly Benefit Cap is reduced on a pro rata basis (i.e., by the percentage obtained by dividing the amount withdrawn by the Contract Value immediate prior to the withdrawal.

LTC Benefits during Phase I reduce the Contract Value dollar-for-dollar[2] until the

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[1] The Specified Person must be the Owner or the spouse of the Owner (if the Owner is a living person) or the annuitant or the spouse of the annuitant (if the Owner is not a living person, i.e., a grantor trust). The Rider may cover joint insureds, e.g., spouses.

[2] This reduction of the Contract Value will reduce the amount of other benefits payable under the Annuity Contract, i.e., the amount payable upon whole or partial surrender (including any guaranteed withdrawal amount), annuitization, or death.

value is reduced to zero, at which time Phase I ends and Phase II begins.[3] Payment of LTC Benefits continues during Phase II (assuming the Specified Person remains eligible). Phase II ends when the aggregate of LTC Benefits paid during Phase II equals the Phase II Benefit Cap, which is the Monthly Benefit Cap multiplied by the length of Phase II.

At issuance the Owner may elect to include inflation protection in the Rider, which will cause the Monthly Benefit Cap to increase by the greater of and the effective annual interest rate credited to the Annuity Contract. Additionally, the Owner can elect to include nonforfeiture benefits in the Rider, which will provide that after the Rider has been in force for a specified period certain benefits will be paid if the Rider is terminated for any reason other than death, maturation of the Annuity Contract, or the expiration of Phase II.

The actual duration of Phase I will be different than the nominal length chosen and specified at the issuance of the Rider. Interest credited to the Annuity Contract will increase the Contract Value, thus slowing the depletion by payment of LTC Benefits; if the Owner elects to receive less than the Monthly Benefit Cap, the depletion of the Contract Value through the payment of LTC Benefits will be slowed. Both of these factors will lengthen Phase I. On the other hand, the optional inflation protection will shorten Phase I. The increase the Monthly Benefit Cap necessary to provide the protection will result in a corresponding increase to the amount payable as the LTC Benefit, thus speeding the depletion of the Contract Value.

If the Specified Person is a chronically ill individual at the scheduled maturity date of the Annuity Contract, the Annuity Contract will remain un-annuitized while the Specified Person remains a chronically ill and LTC Benefit will continue to be paid consistent with the LTC Benefit regime described herein.[4] If upon the scheduled maturity date the Owner elects annuitization and subsequently becomes eligible for LTC Benefits, the timing and amount of LTC Benefits (payable in addition to the annuity payments) will depend on whether LTC Benefits were paid prior to the maturity date. If no LTC Benefits were paid prior to the maturity date, no LTC Benefits will not be paid after the maturity date until after passage of time from the maturity date that is equal to the duration of Phase I. The amount of these LTC Benefit payments be based on a Monthly Benefit Cap equal to the Contract Value immediately before the maturity date divided by the scheduled length of Phase I. If LTC Benefits were paid prior to the maturity date, LTC Benefits will be paid after passage of the number of months equal to the Contract Value immediately before the maturity date divided by the Monthly Benefit

[3] The reduction of the Contract Value through payment of LTC Benefits is not subject to a withdrawal charge.

[4] In other words, the Owner cannot elect to annuitize the value of the Annuity Contract.

Cap applicable to the prior claim. The amount of these LTC Benefit payments will be based on the Monthly Benefit Cap applicable to the prior claim.

In certain circumstances the Rider terminates, most notably if the Owner elects to annuitize the Annuity Contract prior to the maturity date.

Taxpayer imposes a monthly Rider Charge against the Contract Value for the Rider, expressed as a percentage of the Contract Value. The rate of this Rider Charge cannot be increased. The rate will be decreased if imposition of the Rider Charge would cause the Contract Value at the end of the current month to be less than the Contract Value at the end of the prior month. The Rider Charge will not be imposed while LTC Benefits are being paid. The Rider Charge is paid with 'after tax' dollars and reflects an 'arm's length' charge for the Rider

Taxpayer expects to issue a large number of Riders such that the pool of Rider Charges collected will fund any Phase II LTC Benefits payable under any particular Rider. A material amount of Phase II LTC Benefits are expected to be paid, and these Phase II LTC Benefits paid under any particular Rider are expected to materially exceed the aggregate fees collected with respect to that particular Rider. Taxpayer expects its claims experience for this Rider to develop such that for a material number of Specified Persons the amount of Phase II LTC Benefits paid will be substantial relative to the Phase I LTC Benefits paid.

## REQUESTED RULINGS

Taxpayer requests rulings that:

1. the Rider constitutes an insurance contract within the meaning of § 7702B(b)(1);
2. all LTC Benefits will be excludable from the Owner's gross income under § 104(a)(3); and,
3. the investment in the contract (within the meaning of § 72) of the Annuity Contract to which the Rider is attached will not be reduced by the payment of LTC Benefits.

## LAW AND ANALYSIS

*Requested Ruling #1:*

Section 7702B(b)(1) provides that a qualified long-term care insurance contract is "any insurance contract" that has certain attributes.

Neither the Code nor the regulations define the terms "insurance" or "insurance contract." The Supreme Court of the United States has explained that in order for an arrangement to constitute insurance for federal income tax purposes, both risk shifting and risk distribution must be present. Helvering v. Le Gierse, 312 U.S. 531 (1941). The risk transferred must be risk of economic loss. Allied Fidelity Corp. v. Commissioner, 572 F.2d 1190, 1193 (7th Cir. 1978). The risk must contemplate the fortuitous occurrence of a stated contingency, Commissioner v. Treganowan, 183 F.2d 288, 290-91 (2d Cir. 1950), and must not be merely an investment or business risk. Le Gierse, 312 U.S. at 542; Rev. Rul. 2007-47, 2007-2 C.B. 127. In addition, the arrangement must constitute insurance in the commonly accepted sense. See, e.g., Ocean Drilling & Exploration Co. v. U.S., 988 F.2d 1135, 1153 (Fed. Cir. 1993); AMERCO, Inc. v. Commissioner, 979 F.2d 162 (9th Cir. 1992), aff'g 96 T.C. 18 (1991).

Risk shifting occurs if a person facing the possibility of an economic loss transfers some or all of the financial consequences of the potential loss to the insurer, such that a loss by the insured does not affect the insured because the loss is offset by a payment from the insurer. Risk distribution incorporates the statistical phenomenon known as the law of large numbers. Distributing risk allows the insurer to reduce the possibility that a single costly claim will exceed the amount taken in as premiums and set aside for the payment of such a claim. By assuming numerous relatively small, independent risks that occur randomly over time, the insurer smooths out losses to match more closely its receipt of premiums. Clougherty Packing Co. v. Commissioner, 811 F.2d 1297, 1300 (9th Cir. 1987).

The "commonly accepted sense" of insurance derives from all the facts surrounding each case, with emphasis on comparing the implementation of the arrangement with those arrangements known to constitute insurance. Court opinions identify several nonexclusive factors bearing on this, such as the treatment of the arrangement under the applicable state law, AMERCO v. Commissioner, 96 T.C. at 41; the adequacy of the insurer's capitalization and utilization of premiums priced at arm's length, The Harper Group v. Commissioner, 96 T.C. 45, 60 (1991), aff'd 979 F.2d 1341 (9th Cir. 1992); separately maintained funds to pay claims, Ocean Drilling, 988 F.2d at 1151; and the language of the operative agreements and the methods of resolving claims, Kidde Indus. Inc. v. United States, 40 Fed. Cl. 42, 51-53 (1997).

Addressing whether bail bonds constituted insurance, the court in Allied Fidelity Corp. described insurance as

> an agreement to protect the insured against a direct or indirect economic loss arising from a defined contingency whereby the insurer undertakes no present duty of performance but stands ready to assume the financial burden of any covered loss. … [A]n insurance contract contemplates a specified insurable hazard or risk with one party willing, in exchange for the payment of premiums, to agree to sustain economic loss resulting from the occurrence

> of the risk specified and, another party with an 'insurable interest' in the insurable risk. It is important here to note that one of the essential features of insurance is this assumption of another's risk of economic loss.

Allied Fidelity Corp., 572 F.2d at 1193 (citations omitted).

The risk of incurring expenses related to long-term care services is a morbidity risk. A morbidity risk is an insurance risk. See, Haynes v. United States, 353 U.S. 81, 83 (1957) ("Broadly speaking, health insurance is an undertaking by one person for reasons satisfactory to him to indemnify another for losses caused by illness."); cf. Rev. Rul. 68-27, 1968-1 C.B. 315 (medical services for illness or disability provided by staff-model medical clinic for fixed monthly fee involve a normal business risk of an organization engaged in furnishing medical services on a fixed-price basis, rather than an insurance risk).

The crux of the issue is whether there is a possibility that any particular insured could incur a loss reimbursable by the Rider. If there were never any reasonable possibility, the Rider would fail to constitute insurance. For example, there would be no risk shifted to Taxpayer if the Rider were structured such that Contract Value would fund the entirety of LTC Benefits (e.g., if the Annuity Contract purchase payment requirements were sufficiently high that, together with the net increase in Contract Value, there was no meaningful possibility of Taxpayer incurring a loss).

Here, the Specified Person has a risk of economic loss if that person suffers prolonged morbidity, i.e., becomes chronically ill. Through the Rider, in consideration for the Rider Charge, Taxpayer assumes the risk that the Specified Person will be eligible for LTC Benefits in excess of Phase I, i.e., of the Contract Value. The risk assumed by Taxpayer will be distributed across the large number of other Specified Persons who purchase the Rider. The Rider conforms to insurance in the commonly accepted sense. Accordingly, the Rider constitutes an insurance contract for purposes of § 7702B(b).

*Requested Ruling #2*:

Section 104(a)(3) provides that, "except in the case of amounts attributable to (and not in excess of) deductions allowed under section 213 (relating to medical, etc. expenses) for any prior taxable year, gross income does not include amounts received through accident or health insurance (or through an arrangement having the effect of accident or health insurance) for personal injuries or sickness (other than amounts received by an employee, to the extent such amounts (A) are attributable to contributions by the employer which were not includible in the gross income of the employee, or (B) are paid by the employer)."

Section 1.104-1(d) of the Income Tax Regulations provides that "section 104(a)(3) excludes from gross income amounts received through accident or health insurance for personal injuries or sickness (other than amounts received by an employee, to the extent that such amounts (1) are attributable to contributions of the employer which were not includible in the gross income of the employee, or (2) are paid by the employer). . . If, therefore, an individual purchases a policy of accident or health insurance out of his own funds amounts received thereunder for personal injuries or sickness are excludable from gross income under section 104(a)(3)."

Section 7702B(a)(1) states that a qualified long-term care insurance contract shall be treated as an accident and health insurance contract.

Section 7702B(a)(2) states that "amounts (other than policyholder dividends, as defined in section 808, or premium refunds) received under a qualified long-term care insurance contract shall be treated as amounts received for personal injury and sickness…"

Section 7702B(b) defines "qualified long-term care insurance contract."

Section 7702B(c) defines "qualified long-term care services."

Based on Ruling #1, that the Rider constitutes an insurance contract under § 7702B(b)(1), and Taxpayer's representation that the Rider otherwise satisfies the requirements for a qualified long-term care insurance contract under § 7702B, the LTC Benefits paid under the Rider are excludable from gross income under § 104(a)(3).

*Requested Ruling #3*

Under § 6.02 of Rev. Proc. 2011-1, 2011-1 I.R.B. 1, 14, the Service may decline to issue a letter ruling when appropriate in the interest of sound tax administration or on other grounds whenever warranted by the facts or circumstances of a particular case. See also § 2.01, Rev. Proc. 2011-1.

In the interest of sound tax administration, we decline to rule on this request.

RULINGS

We rule that:

1. the Rider constitutes an insurance contract within the meaning of § 7702B(b)(1); and,
2. all LTC Benefits will be excludable from the Owner's gross income under § 104(a)(3).

CAVEATS

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter. No ruling has been requested, and no opinion is expressed, concerning whether the Rider constitutes a qualified long-term care insurance contract, the treatment of any distributions from the Annuity Contract, or the treatment of the payment of the Rider Charges.

This letter ruling is directed only to the taxpayer who requested it. Section 6110(k)(3) of the Internal Revenue Code provides that it may not be used or cited as precedent.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

The rulings contained in this letter are based upon information and representations submitted by the Taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. This office has not verified any of the material submitted in support of the request for rulings; it is subject to verification on examination

Sincerely,

/S/

SHERYL B. FLUM
Chief, Branch 4
Office of Associate Chief Counsel
(Financial Institutions & Products)